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Economics Group

WELLS FARGO SECURITIES

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Manufacturing Activity Gained Steam in July

The manufacturing recovery picked up momentum in July, with the ISM index rising to 54.2. Details paint a brighter picture than previous months as well, but headwinds remain that will keep a full rebound a ways off.

Higher ISM and Stronger Details to Boot

The industrial sector's recovery picked up steam in July, with the ISM manufacturing index climbing up to 54.2. That was a bit better than expected and marked the highest reading in more than a year.

A look at the headline's sub-components show the underlying shape of the sector is improving a bit more rapidly. The production index rose nearly five points to 62.1 in July, and should stay strong at least in the immediate future with the new orders index notching a similar gain to land at 61.5.

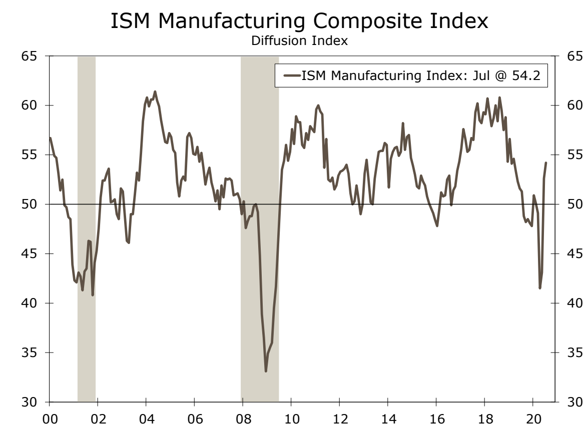
At the same time, the supplier delivery index slipped 1.1 point to 55.8. Normally that would be a negative sign for demand, at least as it relates to capacity. In the current environment, however, the lower reading signals that bottlenecks in the supply chain are continuing to ease up after the index reached nearly a 50 year high of 76.0 back in April.

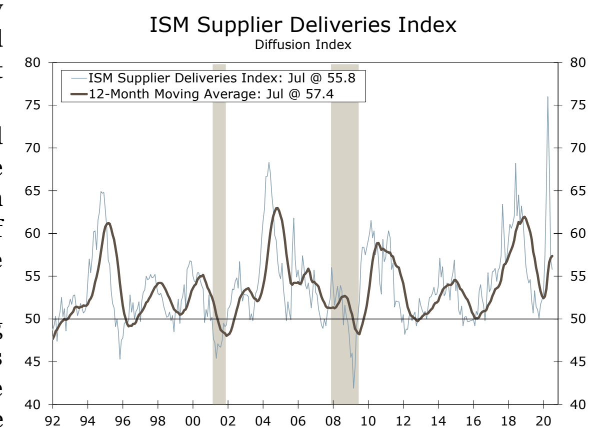
Inventories also weighed on the headline, but for the right reason as activity rebounded quickly last month. The inventory index, which is also included in the headline's composite reading, was consistent with the fastest drawdown in inventories since March.

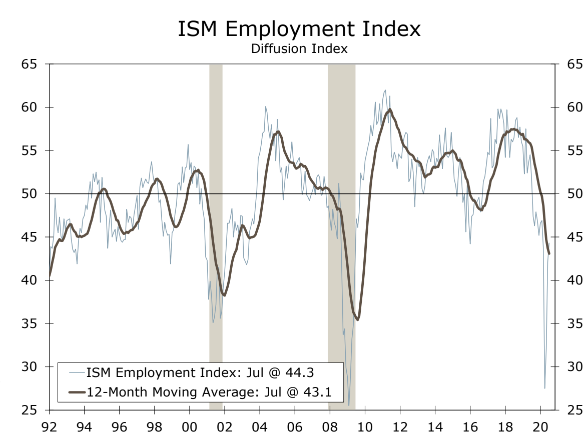
The fifth of the headline's sub-components—employment—showed manufacturers continued to shed workers in July, but at a slower pace. The improvement bodes well for another increase in manufacturing payrolls on Friday, but further gains are going to get harder from here. A number of respondents noted the need to lay off workers ahead and consolidate facilities.

It is worth a reminder that the ISM can be prone to big swings at turning points in the cycle since it is a diffusion index based on the share of firms reporting an increase in activity versus a decrease. It is therefore a measure of the *breadth* rather than the *degree* of change in activity within the manufacturing industry. In that regard, manufacturing output still remains woefully depressed, down 11% from its pre-pandemic peak according to the Fed's June industrial production report. Today's ISM report shows manufacturers are digging out, but activity is still in a deep hole. Comments from the report reinforce that the better month does not necessarily mean a good environment. As a respondent from the fabricated metals industry put it, "while demand in the coming six months is stabilizing, it is at a significant reduction and clear that customers have little confidence in the forecasts."

With depressed global growth, high unemployment and a resurgent virus, the sector continues to face strong headwinds. That said, manufacturers may be poised for a relatively quick recovery compared to services in this particular cycle. The need to limit close contact will weigh unusually heavily on services activity, whereas manufacturing could benefit from a higher share of consumer spending going to goods even as capex remains weak.







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